86 1647

No. 86-

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

HARRISON J. GOLDIN, Comptroller of the City of New York, and THE CITY OF NEW YORK,

Petitioners,

-against-

JAMES BAKER, Secretary of the Treasury of the United States,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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April 10, 1987

QUESTION PRESENTED

Whether the United States Court of Appeals for the Second Circuit erred in determining that section 86 of the Internal Revenue Code (26 U.S.C. § 86) is not a federal tax which violates both the constitutional doctrine of intergovernmental tax immunity and the guarantee of New York City's sovereignty under the Tenth Amendment to the United States Constitution, where section 86 effectively taxes the interest which many social security recipients receive on municipal securities, impairs the City's ability to borrow money, and will thereby conceivably prevent the City from providing essential services and funding capital projects?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
STATEMENT OF THE CASE	1
OPINION AND DECISION BELOW	3
JURISDICTION	4
RELEVANT CONSTITUTIONAL PROVISION AND STATUTE	4
STATEMENT OF THE CASE	7
REASONS FOR GRANTING THE WRIT	13
CONCLUSION	33

TABLE OF AUTHORITIES

Cases:	Page
Boli v. United States, No. 151-86T (Ct. Cl. D.C.)	32 n.4
Eisner v. Macomber, 252 U.S. 189 (1920)	14, 20, 28
Fry v. United States, 421 U.S. 542 (1975)	15, 28
Greiner v. Lewellyn, 258 U.S. 384 (1922)	21
Helvering v. Gerhardt, 304 U.S. 405 (1938)	20
Massachusetts v. United States, 435 U.S. 444 (1978)	13, 25-27
Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926)	14, 21
National Life Ins. Co. v. United States, 277 U.S. 508 (1928)	21-22
Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, opinion on rehearing, 158 U.S. 601 (1895)	passim
Schechter v. United States Treasury Department, No. CV-85-3306 (E.D.N.Y.)	32 n.4

	Page
Shapiro v. Baker, No. 84-2492 (D.N.J.)	32 n.4
South Carolina v. Regan, 465 U.S. 367 (1984)	15, 30-33
United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965)	22-23
Willcuts v. Bunn, 282 U.S. 216 (1931)	13, 21, 24, 27
Constitutional Provisions and Statutes:	
United States Constitution:	
Article I, section 2, clause 3 ...	20
Article I, section 8, clause 1 ...	14, 16, 28
Tenth Amendment	passim
Sixteenth Amendment	14, 19, 28
Internal Revenue Code:	
26 U.S.C. § 86	passim
26 U.S.C. § 86(a)	7, 17
26 U.S.C. § 86(b)	7, 17
26 U.S.C. § 86(c)	7, 17
26 U.S.C. § 103(j)	15, 31 & n.3
28 U.S.C.:	
§ 1254(1)	4
§ 1331	7

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-against-

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Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners the City of New York and Harrison J. Goldin, in his capacity as the City's Comptroller, respectfully request that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this action on January 12, 1987. The Court

of Appeals affirmed the judgment of the United States District Court for the Southern District of New York (Broderick, J.), entered September 12, 1986, which denied petitioners' motion for summary judgment and dismissed the complaint challenging section 86 of the Internal Revenue Code (26 U.S.C. § 86) as violating the constitutional doctrine of intergovernmental tax immunity and the guarantee of the City's sovereignty under the Tenth Amendment to the United States Constitution.

The Court of Appeals agreed with the District Court that section 86 does not contravene the immunity doctrine because that statute is not, as petitioners assert, a tax on interest paid by the City on its securities, but, rather, only a tax on social security income. The Court of Appeals also concurred in the District Court's belief that, in any event, the immunity doctrine is

inapplicable because the adverse impact of section 86 on the City is not constitutionally impermissible. The District Court had reached that conclusion despite its acknowledgement that the statute's burden on the City could be "substantial". While the Court of Appeals found that section 86 imposed only an "indirect" burden on the City, the Court conceded that the statute could cause a decrease in the market for, and thereby force the City to pay higher rates on, its securities. Although the District Court did not explicitly address petitioners' Tenth Amendment claim, the Court of Appeals held that claim to be "totally unsupportable".

OPINION AND DECISION BELOW

The opinion of the United States Court of Appeals for the Second Circuit affirming the District Court's determination that section 86 is not unconstitutional, is

reported at 809 F2d 187, and is reprinted in the Appendix to this petition at pages 1-17. The decision of the United States District Court for the Southern District of New York, which is not officially reported, is reprinted in the Appendix to this petition at pages 19-29.

JURISDICTION

The judgment of the Court of Appeals is dated, and was entered on, January 12, 1987. The jurisdiction of this Court is invoked under 28 U.S.C., section 1254(1). The petition has been filed within the time allowed by law.

RELEVANT CONSTITUTIONAL PROVISION AND STATUTE

United States Constitution:

> Tenth Amendment - Reserved Powers to States -
>
> The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

Internal Revenue Code:

26 U.S.C. § 86. Social Security and tier 1 railroad retirement benefits

(a) In general.- Gross income for the taxable year of any taxpayer described in subsection (b) (notwithstanding section 207 of the Social Security Act) includes social security benefits in an amount equal to the lesser of -

(1) one-half of the social security benefits received during the taxable year, or

(2) one-half of the excess described in subsection (b)(1).

(b) Taxpayers to whom subsection (a) applies. -

(1) In general.- A taxpayer is described in this subsection if -

(A) the sum of -

(i) the modified adjusted gross income of the taxpayer for the taxable year, plus

(ii) one-half of the social security benefits received during the taxable year, exceeds

(B) the base amount.

(2) Modified adjusted gross income.- For purposes of this

subsection, the term "modified adjusted gross income" means adjusted gross income -

(A) determined without regard to this section and sections 221, 911, 931, and 933, and

(B) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

(c) Base amount.- For purposes of this section, the term "base amount" means -

(1) except as otherwise provided in this subsection, $25,000,

(2) $32,000, in the case of a joint return, and

(3) zero, in the case of a taxpayer who -

(A) is married at the close of the taxable year (within the meaning of section 143) but does not file a joint return for such year, and

(B) does not live apart from his spouse at all times during the taxable year.

STATEMENT OF THE CASE

Invoking the jurisdiction of the District Court under 28 U.S.C., section 1331, petitioners commenced this action in October 1985 challenging the constitutionality of that portion of section 86 of the Internal Revenue Code which requires that otherwise tax-exempt interest earned on municipal securities is to be treated as income for the purpose of calculating whether an individual's social security benefits are subject to federal income tax (26 U.S.C. §§ 86 [a], [b], [c]). Petitioners asserted that by mandating the inclusion of such interest income, section 86 contravenes the constitutional doctrine of intergovernmental tax immunity and the guarantee of the City's sovereignty under the Tenth Amendment to the United States Constitution because it effectively imposes a tax on the interest earned by many social security recipients on

municipal securities and consequently impairs the City's ability to borrow money in order to fund essential services and capital projects (CA2, CA5-CA10, CA12-CA14).[1]

In support of their subsequent motion for summary judgment (CA25), petitioners, based upon affidavits from Comptroller Goldin and Richard C. Bain, Jr., Managing Director in the public finance investment banking division of Shearson-Lehman Brothers, Inc., demonstrated that section 86 has decreased the market for, and will thereby force the City to increase the interest rates that it will have to pay on, its securities in order to attract purchasers (CA29-CA32, CA34-CA35). Comptroller

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[1]Unless otherwise indicated, numbers in parentheses preceded by the letters "CA" refer to pages of the Appendix in the Court of Appeals. Numbers preceded by the letter "A" refer to pages of the Appendix to this petition.

Goldin's affidavit also showed how this detrimental effect of section 86 on the City's power to borrow money could impair its ability to serve the needs of its citizens (CA28-CA29).

In or about the same time as plaintiffs moved for summary judgment, respondent James Baker, in his capacity as the Secretary of the United States Treasury, moved for an order dismissing the complaint for lack of standing and for failure to state a claim upon which relief could be granted (CA37-CA38).

Following oral argument on the motions (CA40-CA66), the District Court issued its decision from the bench (A19-A29). After first ruling that petitioners had standing to bring this action (A20-A24), the District Court concluded that section 86 does not implicate the constitutional tax immunity doctrine because the statute is a tax, not on

interest earned on municipal securities, but, rather, only on social security income (A24-A25, A27-A28; see, A22). The District Court also believed that, in any event, the immunity doctrine had been greatly "narrow[ed]" in view of the fact that the federal government can tax the transfer by gift or testamentary devise, and capital gains on the sale, of municipal securities, as well as the salaries of State and municipal employees and a State's commercial business enterprises (A25-A27). The District Court acknowledged, however, that this Court has never overruled its holding in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, opinion on rehearing, 158 U.S. 601 (1895) that the federal taxation of the interest earned on municipal securities is constitutionally prohibited (A26; see, CA56). Although also conceding that the burden placed upon the City by section 86 could be

"substantial", the District Court held that such an adverse impact was "constitutionally permissible" because it was "scarcely more" than the burden which results from the federal taxation of City employees' salaries (A28-A29).

The District Court did not, however, explicitly address petitioners' Tenth Amendment claim.

In its January 12, 1987 opinion (A1-A17), the Court of Appeals agreed with the District Court's conclusion that section 86 does not violate the immunity doctrine because it taxes only social security income rather than interest earned on municipal securities (A10-A13).[2] The Court of

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[2]On the appeal, respondent did not challenge, as he did in the District Court, petitioners' standing to bring this action, which the Court of Appeals implicitly affirmed by addressing the merits of the (Footnote Continued)

Appeals so held even though it recognized, as did the District Court (A20, A25, A28-A29), that section 86 imposes a tax on social security benefits of certain individuals solely because of the interest they receive from otherwise tax-exempt municipal securities (A8, A10), and that section 86 could thereby cause a decrease in the market for, and consequently force the City to pay higher interest rates on, its securities (A8-A9, A13). Pointing to many of the same federal taxes cited by the District Court which this Court has held do not contravene the immunity doctrine, the Court of Appeals, nevertheless, believed that the burden imposed upon the City by section 86 was

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(Footnote Continued)
case. The Court of Appeals also raised, but did not decide, whether the constitutional proscription established by this Court in Pollock against the federal taxation of interest earned on municipal securities, is still good law.

"indirect" and, therefore, not unconstitutional (A14-A16). The Court also ruled that petitioners' Tenth Amendment claim was "totally unsupportable" because it was based upon a "drastic view" as to how section 86 will impair the City, and because the power to tax personal income has been expressly delegated to Congress (A16-A17).

REASONS FOR GRANTING THE WRIT

The Court of Appeals' determination that section 86 is not unconstitutional even though it could impair the City's borrowing power, is without precedent and is in conflict with this Court's decisions in Pollock v. Farmers' Loan & Trust Co., supra, 157 U.S. 429, Willcuts v. Bunn, 282 U.S. 216 (1931), and Massachusetts v. United States, 435 U.S. 444 (1978), which delineate the parameters as to when federal legislation is a constitutionally-prohibited tax under the well-established constitutional doctrine of

intergovernmental tax immunity. Indeed, the Court of Appeals' ruling constitutes, in effect, a repudiation of the immunity doctrine, which is an implied limitation on the taxing power of the Federal and State governments. Under that doctrine, both the Federal and State governments, and their political subdivisions and instrumentalities, enjoy a reciprocal immunity from taxation by each other. Metcalf & Eddy v. Mitchell, 269 U.S. 514, 521-24 (1926). The Court of Appeals' determination also undermines the Tenth Amendment based upon an interpretation of the Federal taxing power under Article I, section 8, clause 1, of, and the Sixteenth Amendment to, the United States Constitution which is contrary to this Court's decisions in Pollock, Eisner v. Macomber, 252 U.S. 189 (1920), and other cases. The Court of Appeals' holding is also inconsistent, in principal, with this Court's

reasoning in Fry v. United States, 421 U.S. 542 (1975) as to the intended purpose of the Tenth Amendment.

The issues raised in this action, which are also now before this Court in South Carolina v. Regan in a challenge to the constitutionality of section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (26 U.S.C. § 103[j]), are of great public importance. The Court of Appeals has created a precedent which, if followed, will subject virtually every State, County and municipality in this country to extraordinary financial hardship because it gives judicial sanction to federal legislation which impairs those entities' ability to raise revenue to fund essential services and capital projects to serve the needs and interests of their citizens.

(1)

In Pollock v. Farmers' Loan & Trust Co., supra, 157 U.S. at 583-86, this Court explicitly ruled that, by virtue of the immunity doctrine and irrespective of Congress' power to lay and collect taxes under Article 1, section 8, clause 1, of the Constitution, the Federal government is prohibited from enacting a statute which either taxes the interest earned on a municipality's securities or which directly infringes on a municipality's borrowing power. Section 86 unconstitutionally does both.

Section 86 effectively taxes interest earned on municipal securities because, as both the District Court and the Court of Appeals properly found (A8, A10, A20, A25, A28), it imposes a tax on social security income of certain individuals solely by virtue of the interest they receive on otherwise

tax-exempt municipal securities. Section 86 mandates that such interest is to be treated as income for the purpose of calculating whether an individual's social security benefits are subject to federal income tax. If a person's "modified adjusted gross income" (which is defined by section 86 to include interest on municipal securities), plus one-half of his or her social security benefits, exceeds a "base amount" of $25,000 for individual taxpayers and $32,000 for taxpayers filing a joint return, then the taxpayer must include as gross income the lesser of one-half of the excess or one-half of the social security benefits received. 26 U.S.C. §§ 86(a), (b), (c).

Thus, an individual taxpayer with $16,000 in non-exempt taxable income, $5,000 in tax-exempt interest income from municipal securities, and $10,000 in social security benefits, will have a "modified adjusted

gross income" of $26,000, or $1,000 more than the "base amount". Since one-half of this excess of the "base amount" ($500) is less than one-half of the social security benefits received, the taxpayer would be required to include $500 as gross income for purposes of computing his or her taxable income. This result arises only because of the mandated inclusion in the foregoing section 86 calculation of the interest received from tax-exempt municipal securities.

Accordingly, by characterizing section 86 as a tax only on social security income, the Court of Appeals' decision ignores reality and exhalts form over substance. Regardless of how the tax is labeled or the source of its payment, many social security recipients who receive interest from municipal securities have less disposable income because that interest is included in the section 86 calculation. Moreover, since,

as petitioners demonstrated (CA29-CA32, CA34-CA35) and as the Court of Appeals acknowledged (A8-A9, A13), section 86 will compel the City to pay higher interest rates on its securities in order to attract purchasers to what is perceived as a less attractive investment, the statute effectively shifts the tax to the City.

To the extent that the Court of Appeals believed that the passage of the Sixteenth Amendment, and decisions by this Court, subsequent to Pollock have "cast doubt" on the continued vitality of Pollock insofar as it prohibits the federal taxation of municipal securities income (A9-A10), the Court was mistaken. This Court has repeatedly held that the sole purpose of the Sixteenth Amendment was to eliminate the requirement of Article I, section 2, clause 3, of the United States Constitution for an apportionment among the States of taxes

imposed on income; and that the Amendment did not extend the powers of Congress to tax any new subject matter, much less interest earned on municipal securities. See, e.g., Eisner v. Macomber, supra, 252 U.S. at 205-06, and the other cases cited therein.

Nor has this Court ever overruled, or questioned the propriety of, Pollock. Indeed, in those cases cited by the Court of Appeals where this Court either has declined to extend the tax immunity doctrine to the transfer upon death, and the capital gains made on the sale, of municipal securities, or to the income of State independent contractors, or where this Court has cut back the doctrine's application to the previously-accepted area of State employees' salaries (A12-A15), this Court has been very careful to distinguish and reaffirm Pollock. Helvering v. Gerhardt, 304 U.S. 405, 417

(1938); Willcuts v. Bunn, supra, 282 U.S. at 225-27; Metcalf & Eddy v. Mitchell, supra, 269 U.S. at 521-22; Greiner v. Lewellyn, 258 U.S. 384, 387 (1922).

The Court of Appeals' determination is also contrary to this Court's decision in National Life Ins. Co. v. United States, 277 U.S. 508 (1928). In that case, this Court invalidated a provision of a Federal income tax law which permitted insurance companies to exclude municipal bond interest from their gross income, but reduced the reserve deduction otherwise available to such companies by the full amount of the exempt interest which was excluded from gross income. In so ruling, this Court noted (277 U.S. at 518-19) that, under the statute before it, an insurance company with tax-exempt income paid as much tax as if its total income had been derived entirely from taxable sources. Thus, the effect of the

statute was to impose, as section 86 does here, a tax on income derived from otherwise tax-exempt municipal securities.

In its opinion, the Court of Appeals disregarded National Life and mistakenly relied, instead, upon United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965) (A11-A12), where the plaintiff insurance company challenged a Federal tax statute which did not allow it to obtain a double deduction of a portion of its tax-exempt income. In that case, this Court, in rejecting the company's claim, distinguished National Life on the ground that, under the statute at issue there, an insurance company would pay the same amount of tax regardless of whether it had tax-exempt income, whereas under the statute in Atlas, an insurance company with such income would pay less tax, not more as the Court of

Appeals believed here (A11). 381 U.S. at 243-44.

In any event, even if section 86 is not, in effect, a tax on otherwise tax-exempt interest earned on municipal securities, which it is, the Court of Appeals' holding is, nevertheless, still inconsistent with Pollock because section 86 directly impairs the City's exercise of its borrowing power. As petitioners demonstrated (CA29-CA32, CA34-CA35), section 86 has caused a decrease in the market for, and will force the City to pay higher interest rates on, its securities. Indeed, the Court of Appeals conceded that section 86 could impose such a burden (A8-A9, A13), which the District Court characterized as possibly "substantial" (A28). Thus, such a burden is anything but "indirect", as the Court of Appeals opined (A16).

Indeed, applying the test enunciated by this Court in Willcuts v. Bunn, supra, 282 U.S. at 228-29, section 86 is invalid because the sale by the City of its securities, with which the statute interferes, is "inseparably connected" with the City's action in borrowing money. Different from the effect of section 86 is the constitutionally-permissible federal taxation of the subsequent private sale or transfer upon death of municipal securities, cited by the Court of Appeals (A14-A15). Those transactions occur after the securities have been issued by, and are not made directly or indirectly on behalf of, the City. Accordingly, they are in no way inextricably tied with the City's exercise of its borrowing power. See Willcuts v. Bunn, supra, 282 U.S. at 227-30. The constitutionally-permissible federal taxation on the income of State employees and independent contractors,

also relied upon by the Court of Appeals (A15), is not even remotely connected with the City's borrowing power.

The Court of Appeals' refusal to invoke the tax immunity doctrine so as to invalidate section 86, is also at odds with this Court's most recent statement as to when the doctrine renders federal legislation unconstitutional. In Massachusetts v. United States, 435 U.S. 444, 459-60 (1978), this Court held that the immunity doctrine prohibits the enactment of a federal statute whose subject is not a "natural and traditional source of federal revenue", and whose effect can conceivably "operate to preclude traditional state activities". Section 86 is unconstitutional under that two-prong test. Whether the statute is viewed as a tax imposed solely on social security benefits, or, in addition, on interest earned on municipal securities, such income has never

before, except in the invalidated statute in Pollock, been the subject of a federal tax.

Moreover, section 86 operates, or, at the very least, can conceivably operate, to preclude the traditional City activities of raising revenue and financing essential services and capital projects. Indeed, the resulting harm is self-evident and is significantly greater than a mere economic burden, which, without more, this Court stated in Massachusetts (435 U.S. at 461), is insufficient to invoke the immunity doctrine. Since, as the Court of Appeals recognized (A8-A9, A13), section 86 impairs the City's borrowing power in the securities market, the City's ability to fund basic services such as fire and police protection and sanitation may be adversely affected (CA29, CA32). Maintenance of the City's infrastructure also could be deferred, resulting in bridges and roads falling into disrepair (CA29). The

City's short-term credit might erode, making it hard to raise City employees' wages and requiring a reduction in the number of City personnel, thereby destroying employee morale and rendering it difficult to recruit replacements (Id.). Thus, without adequate financing as a result of section 86, the City conceivably could be unable to function effectively.

In sum, the Court of Appeals' ruling that section 86 is not a tax which contravenes the immunity doctrine, is inconsistent with this Court's decisions in Pollock, Willcuts, and Massachusetts.

(2)

The Court of Appeals' refusal to hold that section 86 also contravenes the Tenth Amendment to the United States Constitution, is similarly at odds with this Court's decisions as to the scope of the Federal taxing power, and renders the Amendment

meaningless. The Tenth Amendment provides that the "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." Section 86 is not predicated upon a power "delegated" to the Federal government. Contrary to the Court of Appeals' belief (A9-A10, A16-A17), this Court's decisions in Pollock and Eisner, discussed supra, indicate that Congress' power under Article I, section 8, clause 1, of, and the Sixteenth Amendment to, the Constitution to "lay and collect" taxes, does not include the power to impose what here is, in effect, a tax on interest earned on municipal securities.

Moreover, the Court of Appeals' ruling is equally inconsistent, in principle, with this Court's reasoning in Fry v. United States, supra, 421 U.S. at 547 n.7, where this Court stated that the Tenth Amendment

is intended to prevent the impairment of the States' "integrity or ability to function effectively in a federal system." Although acknowledging the adverse impact that section 86 could have on the City (A8-A9, A13), the Court of Appeals mistakenly attributed no legal significance to that burden. It is axiomatic that the power to raise revenue and to spend those funds to serve the needs and interests of its citizens, is central to the concept of the sovereignty of the States and their political subdivisions. Petitioners demonstrated, however, that section 86 abridges or otherwise threatens the City's ability to function in this regard.

(3)

The import of the Court of Appeals' decision upholding the constitutionality of section 86 goes well beyond its adverse impact upon the City. All states, counties and municipalities which raise revenue, as

virtually all do, through the issuance of securities, will be irreparably harmed if the precedent established by the Court of Appeals is allowed to stand. The market for those securities will decrease, as they already have with respect to the City's bonds and notes. As a result, governmental entities will have to pay higher interest rates on their securities in order to attract purchasers, which, in turn, will ultimately cause a shrinkage in the funds available for basic services and capital projects.

Given such potentially disastrous results, we submit that a Writ of Certiorari should issue to review the Court of Appeals' judgment. This is particularly warranted in view of the fact that this Court, in South Carolina v. Regan, is already presently considering the scope of the immunity doctrine and the Tenth Amendment, as they relate to the federal taxing power, in a

challenge to the constitutionality of section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (26 U.S.C. § 103[j]).[3] Significantly, Justice O'Connor of this Court, citing Pollock in her opinion concurring in this Court's assumption of original jurisdiction in that case, which opinion was joined in by Justices Rehnquist and Powell, observed that South Carolina's intergovernmental tax immunity claim against section 310(b)(1) has a "significant historical basis". 465 U.S. 367, 401 (1984). Since the issues raised here with respect to section 86 are analogous to, and are at least of equally compelling public importance as

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[3]Section 103(j) requires that publicly-issued securities of a State or local government with maturities of greater than one year must be issued in registered, rather than bearer, form in order for the interest earned on such securities to be exempt from federal income taxation.

those asserted in South Carolina v. Regan, this petition should be granted.[4] The Special Master appointed by this Court to develop a record in South Carolina v. Regan (465 U.S. at 382) filed his report on January 23, 1987. If this petition is

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[4]This is especially true in view of the recurring litigation challenging the constitutionality of section 86. At least three other federal actions have been brought, thus far, contesting the statute's legality: one by the County Executive of Essex County, New Jersey (Shapiro v. Baker, No. 84-2492 [D.N.J.]); and two by individual taxpayers. Schechter v. United States Treasury Department, No. CV-85-3306 (E.D.N.Y.); Boli v. United States, No. 151-86 T (Ct. Cl. D.C.). The complaints in Shapiro and Boli have been dismissed on the merits by the District Court and the Court of Claims, respectively. However, the Court of Claims' judgment in Boli is now on appeal to the United States Court of Appeals for the Federal Circuit. We have been informed by counsel for the plaintiff in Schechter that the complaint in that action was dismissed on procedural grounds; that the District Court's judgment will be amended to reflect that the dismissal was without prejudice; and that the plaintiff will file a new complaint in that action.

granted, we respectfully request that this case be heard with South Carolina.

CONCLUSION

THE PETITION FOR A WRIT OF CERTIORARI SHOULD BE GRANTED.

Respectfully submitted,

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Corporation Counsel of the
City of New York,
Attorney for Petitioners.

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FAY LEOUSSIS,
BARRY P. SCHWARTZ,
of Counsel.

*Counsel of Record

April 10, 1987

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OCTOBER TERM, 1986

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Petitioners,

-against-

JAMES BAKER, Secretary of the Treasury of the United States,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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April 10, 1987

TABLE OF CONTENTS

Page

Cases:

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND ENTERED JANUARY 12, 1987 1

JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED AND ENTERED SEPTEMBER 12, 1986 18

DECISION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK RENDERED JULY 23, 1986 19

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND ENTERED JANUARY 12, 1987

No. 391 - August Term, 1986
(Argued: December 1, 1986
Decided: January 12, 1987)
Docket No. 86-6150

HARRISON J. GOLDIN, Comptroller of the City of New York, and THE CITY OF NEW YORK,

Plaintiffs-Appellants,

-against-

JAMES BAKER, Secretary of the Treasury of the United States,

Defendant-Appellee.

Before:

FEINBERG, Chief Judge, NEWMAN and MINER,

Circuit Judges.

Appeal by New York City from judgment of the United States District Court for the Southern District of New York, Vincent L. Broderick, J., dismissing its complaint. The

City claimed that a federal tax provision violated the intergovernmental tax immunity doctrine. Affirmed.

BARRY P. SCHWARTZ, New York, NY, Assistant Corporation Counsel of the City of New York (Frederick A.O. Schwarz, Jr., Corporation Counsel of the City of New York, Leonard Koerner, Fay Leoussis, Assistant Corporation Counsel, of Counsel), for Plaintiffs-Appellants.

FREDERICK M. LAWRENCE, New York, NY, Assistant United States Attorney for the Southern District of New York (Rudolph W. Giuliani, United States Attorney for the Southern District of New York, Nancy Kilson, Assistant United States Attorney, of Counsel), for Defendant-Appellee.

FEINBERG, Chief Judge:

This case requires us to examine the scope of the intergovernmental tax immunity doctrine. Plaintiffs Harrison J. Goldin, Comptroller of the City of New York, and the City (collectively referred to herein as

the City) appeal from a judgment of the United States District Court for the Southern District of New York, Vincent L. Broderick, J., denying the City's motion for summary judgment and granting the motion of defendant Secretary of the Treasury to dismiss the City's complaint for failure to state a claim upon which relief can be granted. The City challenges the constitutionality of section 86 of the Internal Revenue Code of 1954 as amended, 26 U.S.C. § 86, Pub. Law 98-21 § 121, 97 Stat. 65 (1983).[1] The City contends that section

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[1]Section 86 provides, in relevant part, as follows:

§ 86. Social security and tier 1 railroad retirement benefits

(a) In general. - Gross income for the taxable year of any taxpayer described in subsection (b) (notwithstanding section 207 of the Social Security Act) includes social security benefits in an amount equal to the lesser of -

(1) one-half of the social security

(Footnote Continued)

86 effectively places a tax on municipal bond interest and therefore violates the intergovernmental immunity doctrine and the Tenth Amendment of the United States

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(Footnote Continued)

benefits received during the taxable year, or

(2) one-half of the excess described in subsection (b)(1).

(b) Taxpayers to whom subsection (a) applies. -

(1) In general. - A taxpayer is described in this subsection if

(A) the sum of

(i) the modified adjusted gross income of the taxpayer for the taxable year, plus

(ii) one-half of the social security benefits received during the taxable year, exceeds

(B) the base amount.

(2) Modified adjusted gross income. - For purposes of this subsection, the term "modified adjusted gross income" means adjusted gross income -

(A) determined without regard to this section and sections 221, 911, 931, and 933, and

(B) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

(Footnote Continued)

Constitution. Because we think section 86 is constitutionally sound, we affirm.

In 1983, Congress enacted section 86 in order to tax a portion of the social security benefits received by persons who have substantial income from other sources. See House Conf. Rep. No. 47, 98th Cong., 1st Sess. 122-23, reprinted in 1983 U.S. Code Cong. & Ad. News 404, 412-13. Section 86 requires that, if a taxpayer's "modified adjusted gross income" plus one-half of his

---

(Footnote Continued)

(c) Base amount. - For purposes of this section, the term "base amount" means -

(1) except as otherwise provided in this subsection, $25,000,

(2) $32,000, in the case of a joint return, and

(3) zero, in the case of a taxpayer who -

(A) is married at the close of the taxable year (within the meaning of section 143) but does not file a joint return for such year, and

(B) does not live apart from his spouse at all times during the taxable year.

social security benefits exceeds a certain "base amount," a portion of the taxpayer's social security beneifts shall be included in his taxable income. The amount included in taxable income is either (i) one-half of the social security benefits received or (ii) one-half of the amount by which his modified adjusted gross income plus one-half of his social security benefits exceeds his base amount, whichever is less. The base amount is $32,000 for taxpayers filing joint returns and $25,000 for most other taxpayers. In determining a taxpayer's modified adjusted gross income, section 86 includes "interest received or accrued by the taxpayer during the taxable year which is exempt from tax." 26 U.S.C. § 86(b)(2)(B). It is this last proviso that gives rise to the controversy before us.

The Secretary's excellent brief offers two examples to illustrate the operation of section 86.

> Taxpayer A, who files a joint return, has an adjusted gross income . . . of $29,000. He received $2,000 in tax-exempt interest income and $5,000 in Social Security benefits. To compute A's "modified adjusted gross income," add his tax-exempt interest income ($2,000) to his adjusted gross income ($29,000). Thus, his "modified adjusted gross income" is $31,000. Section 86 applies to A only if this sum plus one-half of his Social Security benefits exceeds the base amount of $32,000. In this example, A's "modified adjusted gross income" ($31,000) plus one-half of his Social Security benefits ($2,500) totals $33,500, and exceeds his base amount by $1,500. Some portion of his Social Security benefits is thus taxable. Because one-half of the excess ($750) is less than one-half of the total Social Security benefits received, the taxpayer would be required to include $750 from his Social Security benefits in his gross income for purposes of computing his taxable income.
>
> Taxpayer B, who files a joint return, has an adjusted gross income of . . . $35,000. He also received $2,000 in tax-exempt

interest income and $5,000 in Social Security benefits. B's "modified adjusted gross income" is thus $37,000; when added to one-half of his Social Security benefits, the total is $39,500, which exceeds his base amount by $7,500. Some portion of his Social Security benefits is thus taxable. Because one-half of his Social Security benefits ($2,500) is less than one-half of the excess, only one-half of his Social Security benefits is included in gross income for purposes of computing taxable income.

Thus, for certain taxpayers (like taxpayer A), the effect of section 86 can be as follows: If they have interest income from tax-exempt municipal securities, a portion of their social security benefits will be taxed. On the other hand, if that tax-exempt income did not exist, their social security benefits would be taxed to a lesser degree or not at all. This effect of section 86 operates on a fairly narrow group of taxpayers. Nonetheless, it could make municipal securities marginally less attractive to investors and thereby increase the

interest rate the City has to pay to attract lenders. The City contends that section 86 is a tax on interest income from municipal securities and that it threatens the City's ability to provide essential services by impairing the City's ability to borrow money.

In support of its claim that section 86 violates the intergovernmental immunity doctrine, the City relies on Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, modified on rehearing, 158 U.S. 601 (1895). In Pollock, the Supreme Court held a federal statute imposing a tax on income from municipal bonds to be unconstitutional, see 157 U.S. at 583-86. Whether the rule of Pollock has survived the ninety years since it was announced is questionable, see South Carolina v. Regan, 465 U.S. 367, 404-15 (1984) (Stevens, J., dissenting). The passage of the Sixteenth Amendment to the Constitution in 1913 and numerous Supreme

Court decisions since that time have cast doubt on the vitality of Pollock. We need not face this question, however, since we find that section 86 is not a tax on interest paid by the City.

By its terms, section 86 is part of a tax on social security income. Judge Broderick correctly pointed out that the tax is intended to strengthen the social security system by requiring "taxpayers who have a comfortable flow of income" to pay a tax on part of their social security benefits. See S. Rep. No. 23, 98th Cong., 1st Sess. 25-28, reprinted in 1983 U.S. Code Cong. & Ad. News 143, 166-69. Admittedly, tax-exempt municipal bond income will, in certain cases, affect this new tax on social security benefits. However, that by itself does not make section 86 a direct tax on municipal bond income.

Indeed, in United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965), the Supreme Court upheld a statute that, like section 86, required certain recipients of tax-exempt income to pay a larger tax than they would have paid had they not received the tax-exempt income. In Atlas, the Court was presented with a statute that required life insurance companies to allocate a pro rata share of all their income, tax-exempt or otherwise, to their reserves. The reserves were required in order to guarantee payment to policyholders. Income placed in the reserves was not taxed. Rather than include a pro rata share of its tax-exempt income in its reserves, the insurance company naturally preferred to attribute none of its tax-exempt income to the mandatory reserve deposits; using regular income for this purpose would reduce its tax bill by decreasing the amount of taxable

income remaining after it took its reserve deduction. In an argument similar to that advanced by the City here, the company contended that the statute, as applied, was unconstitutional because an insurance company that received tax-exempt income from "investing its 'idle' assets in municipal bonds" would be subject to a greater tax than an insurance company that did not make "the additional investment at all." 381 U.S. at 250. The Supreme Court firmly rejected this view, adopting instead "the principle of charging exempt income with a fair share of the burdens properly allocable to it." 381 U.S. at 251. The Court concluded that an added burden on tax-exempt income did not constitute a tax on that income.

Furthermore, Pollock has not been a barrier to taxes on the profits from the sale of municipal bonds, Willcuts v. Bunn, 282 U.S. 216 (1931), or to estate taxes on their

transfer at death, Greiner v. Lewellyn, 258 U.S. 384 (1922). Section 86 is merely another example of a federal tax that makes a municipal security marginally less attractive - here, to some persons who also receive social security benefits. A taxpayer who does not receive such benefits is affected only remotely, if at all, by section 86, even if the taxpayer owns municipal bonds. In short, section 86 is not a tax on income from that type of security.

The City argues that even if the narrow rule of Pollock does not cover this case, the broader principles of intergovernmental immunity underlying Pollock require us to invalidate the statute. We disagree. The origins of intergovernmental tax immunity lie as far back as McCulloch v. Maryland, 4 Wheat. 316 (1819), and Collector v. Day, 11 Wall. 113 (1871). The policy behind the doctrine is

restricted to insuring that a federal tax does not destroy the state's ability to function:

> [T]he Court was concerned with the continued existence of the states as governmental entities, and their preservation from destruction by the national taxing power. The immunity which it implied was sustained only because it was one deemed necessary to protect the states from destruction by the federal taxation of those governmental functions which they were exercising when the Constitution was adopted and which were essential to their continued existence.

Helvering v. Gerhardt, 304 U.S. 405, 414 (1938).

Because federal taxes that place indirect burdens on states and municipalities have not generally implicated this policy, the intergovernmental immunity doctrine has not been a bar to a broad array of taxes at least as burdensome on states and municipalities as section 86, e.g., Willcuts v. Bunn, 282 U.S. 216 (tax on profits from sale of municipal bonds); Greiner v. Lewellyn, 258

U.S. 384 (tax on transfer of municipal securities after death); Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) (tax on income of independent contractor earned from contracts with a state); Helvering v. Gerhardt, 304 U.S. 405 (tax on salaries of employees of state-controlled corporation). Simply put, "an economic burden on traditional state functions without more is not a sufficient basis for sustaining a claim of immunity." Massachusetts v. United States, 435 U.S. 444, 461 (1978).

The Court stated as long ago as Willcuts v. Bunn, 282 U.S. at 225:

> The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general obligation of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government.

Section 86, which is a tax on social security benefits, imposes just this kind of indirect burden. See Shapiro v. Baker, No. 84-2492, slip op. (D.N.J. Nov. 5, 1986). The intergovernmental immunity doctrine does not apply.

The City's argument that section 86 violates the Tenth Amendment of the United States Constitution merits little discussion. The Tenth Amendment provides:

> The powers not delegated to the United States by the Constitution nor prohibited by it to the States, are reserved to the States respectively, or to the people.

The City claims that section 86 impairs its "ability to function effectively in a federal system," citing Fry v. United States, 421 U.S. 542, 547 n.7 (1975). Such a drastic view of section 86 is totally unsupportable. Moreover, "[b]ecause the power to tax private income has been expressly delegated to Congress, the Tenth Amendment has no

application to this case." South Carolina v. Regan, 465 U.S. at 418 (Stevens, J., dissenting).

Accordingly, the judgment of the district court is affirmed.

JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

HARRISON J. GOLDIN, Comptroller of The City of New York, and THE CITY OF NEW YORK,

Plaintiffs,

-against-

JAMES BAKER, Secretary of The Treasury of the United States,

Defendant.

JUDGMENT
85 Civ. 7788 (VLB)

For reasons set forth on the record on July 23, 1986, the complaint is dismissed for failure to state a claim for which relief can be granted, and the plaintiffs' motion for summary judgment is denied.

Dated: New York, New York
September 12, 1986

United States District Judge

DECISION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

HARRISON J. GOLDIN, Comptroller of The City of New York, and THE CITY OF NEW YORK,

Plaintiffs,

-against-

JAMES BAKER, Secretary of The Treasury of the United States,

Defendant.

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85 Civ. 7788 (VLB)

July 23, 1986
11:57 o'clock am

Before:
HON. VINCENT L. BRODERICK,
District Judge

APPEARANCES

NEW YORK CITY LAW DEPARTMENT
OFFICE OF THE CORPORATION COUNSEL
BY: ALEXANDRA S. BOWIE and
MICHAEL D. YOUNG,
Attorneys for plaintiffs

UNITED STATES ATTORNEY
BY: FREDERICK M. LAWRENCE,
Assistant United States Attorney
Attorney for defendant

THE COURT: The first question which I must consider is that of the standing of the plaintiffs to bring this action. The tax which is under attack, 26 USC Section 86, is a tax which impinges directly upon a small segment of the total universe that receives social security payments, and the direct effect of the tax, when it is applicable, is to require the members of that small segment to pay a tax upon a part of the social security payments which they have received. The income from municipal bonds which they own will play a role in placing them in the taxable bracket.

At first blush, therefore, it would seem to be these affected taxpayers and not the Comptroller of the City of New York or the City of New York itself who have standing.

The plaintiffs have, however, alleged a direct impact which this tax has or may have on them. Thus, the complaint alleges that

the City of New York is heavily dependent on funds which are raised by the sale of bonds to finance capital projects and notes to finance current operations. It alleges that these municipal securities have been purchased by elderly taxpayers who have invested because, among other things, of their expectation that the interest from those municipal bonds and notes will be free of tax.

It alleges that the impact of Section 86 has been to cause many of these elderly investors to refrain from investing in municipal securities, as a result of which the City is losing an important segment of the market for its securities.

It further alleges that the loss of these elderly citizens as investors will harm the City and the City's residents. The City will be forced, according to the complaint, to pay higher interest, and the combination of

the loss of participants in the market and the increased cost of money will mean that fewer funds will be available to fund capital projects and to provide essential services.

The City, in substance, characterizes the tax provided by Section 86 as being a tax on municipal bonds. I do not accept that characterization, but I am satisfied that the City has alleged a direct impact upon itself from this tax and a prospective impact in the future which is sufficient to warrant its invocation of the jurisdiction of this court.

The government has argued that the impact alleged is conjectural, and it may very well be that if we proceeded to the development of a detailed record, it would be found to be without substantial foundation.

I am now dealing, however, with a complaint, the allegations of which, for purposes of this ruling, I accept as true,

and that complaint alleges distinct injury to the City of New York and it is injury that would certainly be corrected by a favorable decision.

During the colloquy this morning I discussed the Atlas case. There are certainly many differences between this case and the Atlas case. One of them is that the arguments made in the Atlas case, with respect to the impact of the use of the allocation of tax exempt income in the determination of insurance company taxation, were made by the taxpayer and not by any issuer of tax exempt bonds.

While the city in this case has apparently been solicited by various individual taxpayers to take up the cudgels, the continued vitality of tax exemption for municipal bonds that is being urged is certainly in its own interest.

It is arguable that the City's interest here is a long-term interest in preserving the integrity of the tax exempt status of its bonds and notes and that that interest should be urged in Congress rather than in the courts, but the issue it raises is a direct constitutional issue, and in my judgment is appropriate to be heard in this court.

In sum, I find that the City and Mr. Goldin, as the comptroller of the City, have standing in this action. That finding with respect to standing is not, however, a finding with respect to anything more than the plaintiff's [sic] right to raise the constitutional issue.

I now pass to the government's motion to dismiss the complaint.

The tax provided for by Section 86 is a tax on social security payments received by a taxpayer. However that tax is measured,

if a taxpayer owning municipal bonds does not receive social security payments, he will not be subject to the tax. Tax exempt income comes into play as a factor to be considered in determining the total flow of income to that taxpayer. It goes into the computation of whether the taxpayer is pushed into a bracket which will require that he pay some part of his income tax to be measured by social security payments.

The argument of the plaintiffs is that there is a constitutional doctrine of intergovernmental tax immunity which prevents the national government, directly or indirectly, from taxing municipal securities.

Plaintiff relies [sic] on the Pollock case and a long line of cases antecedent to Pollock. There is, of course, a progression from the time of Pollock to the present time which has served considerably to narrow the

concept in practice of intergovernmental tax immunity.

There was a time when the federal government could not constitutionally tax the salaries of state officials, just as state and city governments could not constitutionally tax the salaries of federal officials. To date there has been no direct inroad into the constitutional prohibition against taxation of municipal bonds as to income, but it is clear today that the transfer of such bonds by gift or testamentary device [sic] is subject to tax, and any capital gains on the sale of municipal bonds is subject to tax.

It is also clear today that commercial business enterprises of a state may be subject to federal income taxation.

In short, the development of the law since the time of Pollock has been to permit substantial inroads into the once mighty wall

of separation between federal and state activities.

This background may or may not be directly germane to the question before me because here we do not have any effort by the federal government to tax directly the income from municipal bonds.

We have, instead, the effort by the federal government to deal with a real and pressing problem of recent years, to wit: The rather shaky financial status of the social security system.

The thrust of Section 86 is to require taxpayers who have a comfortable flow of income to pay a tax on some part of the social security payments which they receive.

There is a cap on the income tax attributable to social security that they must pay. Whatever their financial situation, they need not pay tax on more than 50 percent of the social security benefits received.

Municipal bond income comes into the picture with respect to a measure of the total income flow. This scarcely constitutes the tax imposed by Section 86 as being a tax on tax exempt income.

The burden placed upon plaintiffs by operation of the Section 86 tax structure may be a substantial one. It is scarcely more substantial than the burden which was placed upon states and municipalities by the determination that the salaries of their employees were subject to federal tax.

Here the plaintiffs argue that the impact will be to raise the cost of money to the city. The decision to permit the federal taxation of city and state employees which was determined to be constitutionally permissible substantially raised the cost of city and state government.

In sum, recogizing that there may be a fairly substantial impact upon the plaintiffs

from the operations of the tax imposed under Section 86, I find that that is an impact which is constitutionally permissible.

I grant the defendant's motion to dismiss the complaint, and I deny the plaintiffs' motion for summary judgment.

(4)

No. 86-1647

In the Supreme Court of the United States

OCTOBER TERM, 1986

HARRISON J. GOLDIN, COMPTROLLER OF THE CITY OF NEW YORK, ET AL., PETITIONERS

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Section 86 of the Internal Revenue Code provides that Social Security recipients who have substantial amounts of other income must include in their gross income for tax purposes up to one-half of the Social Security benefits that they receive. The question presented is whether Section 86 is unconstitutional because the measure of the other income that triggers the tax on Social Security benefits includes interest on municipal bonds.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	6
Conclusion	10

TABLE OF AUTHORITIES

Cases:

Fry v. *United States*, 421 U.S. 542 (1975)	9
Great Atlantic and Pacific Tea Co. v. *Grosjean*, 301 U.S. 412 (1937)	8
Greiner v. *Lewellyn*, 258 U.S. 384 (1922)	9
Helvering v. *Gerhardt*, 304 U.S. 405 (1938)	9
Maxwell v. *Bugbee*, 250 U.S. 525 (1919)	8
Pollock v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895)	4
Trainer v. *United States*, 800 F.2d 1086 (Fed. Cir. 1986), cert. denied, No. 86-904 (Mar. 2, 1987)	8
United States v. *Atlas Life Ins. Co.*, 381 U.S. 233 (1965)	5, 7, 8
Willcuts v. *Bunn*, 282 U.S. 216 (1931)	8

Constitution and Statutes:

U.S. Const.:	
Art. I, § 8	4
Amend. V (Due Process Clause)	8
Amend. X	4, 6, 9
Internal Revenue Code of 1954 (26 U.S.C.):	
§ 56 (1976 ed.)	8
§ 62	3
§ 86	2, 4, 5, 6, 7, 8, 9
§ 86(a)	2
§ 86(b)(2)	3
§ 86(b)(2)(A)	3

Cases—Continued: Page

§ 86(b)(2)(B) 3
§ 86(c) 2
§ 103 3
§ 103(j) 10
§ 221 3
§ 911 3
§ 931 3
§ 933 3

Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 80 2

Miscellaneous:

S. Rep. 98-23, 98th Cong., 1st Sess. (1983) 2

In the Supreme Court of the United States

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-17) is reported at 809 F.2d 187. The opinion of the district court (Pet. App. 19-29) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 12, 1987. The petition for a writ of certiorari was filed on April 12, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 86 was added to the Internal Revenue Code [1] by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 80. It was enacted to strengthen the Social Security system by requiring taxpayers who have substantial income from other sources to pay a tax on a portion of their Social Security benefits. See S. Rep. 98-23, 98th Cong., 1st Sess. 25-28 (1983). The portion subject to tax may in no event exceed 50%—the portion that corresponds to FICA taxes paid by the employer rather than by the employee. In order to alleviate any burden on the neediest recipients of Social Security, the tax is "phased in" by having the percentage of benefits subject to tax increase from 0% to 50% as the recipient's other income goes up.

The phase-in is accomplished by a statutory formula under which the taxpayer must determine whether his "modified adjusted gross income," plus one-half of his Social Security benefits, exceeds a specified "base amount." If it does, a portion of his Social Security benefits, up to one-half of those benefits, must be included in gross income for tax purposes.[2] The "base amount" is $32,000 for taxpayers filing a joint return and $25,000 for most other taxpayers (I.R.C. § 86(c)).

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

[2] The amount included in gross income is the lesser of: (i) one-half of the Social Security benefits received; or (ii) one-half of the amount by which the taxpayer's "modified adjusted gross income" plus one-half of his Social Security benefits exceeds his base amount. I.R.C. § 86(a). See Pet. App. 7-8 (giving examples).

Section 86(b)(2) defines "modified adjusted gross income" in a manner designed to reflect the taxpayer's true economic income in order to accomplish the legislative purpose of sparing only relatively needy Social Security recipients from taxation of their benefits. Section 86(b)(2)(A) accordingly provides that "modified adjusted gross income" includes several varieties of income that are exempt from tax, such as certain income from sources outside the United States.[3] In addition, and most relevant for present purposes, Section 86(b)(2)(B) provides that the term also includes "the amount of interest received or accrued by the taxpayer * * * which is exempt from tax."

2. Petitioners issue municipal bonds the interest on which is exempt from tax under Section 103 of the Code. They brought this suit in the United States District Court for the Southern District of New York to challenge the constitutionality of Section 86. Petitioners argued that the inclusion of tax-exempt interest income in "modified adjusted gross income" is, in effect, a tax on the income from municipal bonds. This argument was based on the fact that, in certain circumstances, Section 86 may cause a recipient of municipal bond income to be taxed on a

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[3] Section 86(b)(2)(A) provides that "modified adjusted gross income" means "adjusted gross income" (as defined in I.R.C. § 62) without regard to the following deductions or exclusions listed in Section 86(b)(2)(A): (i) the deduction for two-earner married couples (I.R.C. § 221); (ii) the exclusion of foreign earned income (I.R.C. § 911); (iii) the exclusion of income of United States citizens who derive a certain percentage of their income from sources within United States Possessions (I.R.C. § 931); and (iv) the exclusion of income for residents of Puerto Rico (I.R.C. § 933).

portion of his Social Security benefits, whereas he would not be so taxed in the absence of such tax-exempt income. Petitioners contended that this statutory scheme violates constitutional principles of intergovernmental tax immunity and hence exceeds the authority of the United States to "lay and collect taxes" contained in Article I, Section 8 of the Constitution. Petitioners also argued that Section 86 violates the Tenth Amendment by impairing the sovereign functions of state and local governments.

The district court issued an oral opinion (Pet. App. 19-29) granting the government's motion to dismiss the suit for failure to state a claim.[4] The court first observed (*id.* at 25-26) that petitioners placed their chief reliance on the version of the tax immunity doctrine announced in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), where this Court held that the federal government may not lay a direct tax on interest income received by municipal bondholders. "There is," the district court pointed out, "a progression from the time of *Pollock* to the present time which has served considerably to narrow the concept in practice of intergovernmental tax immunity" (Pet. App. 25-26).

The district court found it unnecessary to determine precisely what remains of the *Pollock* doctrine, however, because it held that Section 86 does not impose any tax whatsoever on municipal bond interest income. The court explained that Section 86 was designed to help strengthen the "shaky financial

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[4] The court at the same time denied the government's motion to dismiss for lack of standing (Pet. App. 20-24). The government did not renew its standing argument in the court of appeals.

status of the social security system" by "requir[ing] taxpayers who have a comfortable flow of income to pay a tax on some part of the social security payments which they receive" (Pet. App. 27). The fact that municipal bond interest income is one component of a taxpayer's "total income flow" does not, in the court's view, render the tax imposed by Section 86 "a tax on tax exempt income" (Pet. App. 28). The court acknowledged that Section 86's mode of determining when and to what extent Social Security benefits are taxed might conceivably have some effect on municipal finances. But it explained that this consequence is no more a constitutional problem than Congress's taxation of the salaries of municipal employees, which surely has a substantial adverse impact on municipal finances.

3. The court of appeals unanimously affirmed (Pet. App. 1-17). It noted that, in light of subsequent decisions by this Court, it is "questionable" whether the decision in *Pollock* was still good law (Pet. App. 9-10). Like the district court, however, the court of appeals determined that it need not reach that issue because Section 86 does not impose a tax upon interest paid by local governments, but instead imposes a tax upon Social Security benefits received by individual taxpayers from the federal government (Pet. App. 10). The court acknowledged that a person's receipt of tax-exempt interest income, like his receipt of other varieties of taxable and tax-exempt income, will in certain cases affect the taxability of his Social Security benefits. Citing *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233 (1965), however, the court explained that such an indirect tax consequence of receiving tax-exempt income cannot be equated with a direct tax upon that income

(Pet. App. 11-12). Finally, the court concluded that petitioners' Tenth Amendment argument "merits little discussion" because the power to tax private income has expressly been delegated to Congress and, moreover, because there is no support for the view that Section 86 impairs the ability of state governments, or political subdivisions thereof, to function effectively in the federal system (Pet. App. 16-17).

ARGUMENT

Petitioners' contention that Section 86 violates constitutional principles of intergovernmental tax immunity was correctly rejected by both courts below. Petitioners do not allege, nor is there, any conflict among the circuits on the questions presented,[5] and there is likewise no conflict with any decision of this Court. There is, accordingly, no reason for further review.

1. Whatever the conclusion regarding the constitutionality of a direct federal tax on municipal bond income, there is no basis for concluding that Section 86 of the Code exceeds Congress's constitutional power. Section 86 does not impose a tax on income from municipal bonds. It taxes only Social Security benefits; in the absence of receipt of such benefits no tax is imposed.

It is true that Section 86 does take account of municipal bond income in determining whether and to what extent a tax on Social Security benefits will

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[5] Petitioners' claim has been advanced in three other lawsuits. See Pet. 32 n.4. It has not been accepted by any court, and it has been rejected on the merits by the Claims Court; no other court of appeals has yet considered it.

be triggered.[6] But it is well established that such an attenuated effect of the receipt of municipal bond income on the taxability of other income raises no serious constitutional question. In *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233 (1965), this Court upheld a statute that, like Section 86, had the effect in certain circumstances of increasing the tax on a taxpayer's other income because of an increase in its receipt of tax-exempt income. The statute at issue there required life insurance companies to allocate a pro rata share of all their income, including their tax-exempt income, to insurance reserves. Because income attributed to life insurance reserves was nontaxable under separate provisions of the Code, the taxpayer pointed out that the required pro rata allocation had the effect of increasing the tax on its other income, since every dollar of municipal bond income allocated to its reserves would drive a dollar of other income out of the reserves and into the taxable category. The taxpayer therefore contended that the statute, by thus increasing its tax liability over what it otherwise would have been, in effect imposed an unconstitutional tax on its municipal bond interest.

This Court squarely rejected the insurance company's argument, holding that this indirect effect on its tax liability was not impermissible and reasoning that there is no constitutional impediment to "the principle of charging exempt income with a fair

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[6] It is, however, only a "fairly narrow group of taxpayers" (Pet. App. 8) for whom Section 86 is likely to cause the receipt of tax-exempt income to have some effect on their federal tax bill. That "narrow group" is composed of those Social Security recipients whose other income, excluding the adjustment for tax-exempt income, is close to the "base amount" that triggers the tax on Social Security benefits.

share of the burdens properly allocable to it" (381 U.S. at 251). The same reasoning applies here. In a statute designed to tax in part the Social Security benefits of those who can most easily afford it, *i.e.*, those who have a sufficiently high level of other income, it is fair—and constitutional—to include tax-exempt income in the measure of other income that triggers the tax.[7]

The mere fact that there may be a class of taxpayers who, by virtue of Section 86, will conceivably be less inclined to purchase municipal bonds, thereby affecting the marketability of such bonds to some slight degree, is plainly insufficient to make the statute unconstitutional. This Court has upheld federal tax provisions that have a much greater impact on the marketability of state and municipal bonds. See, *e.g.*, *Willcuts* v. *Bunn*, 282 U.S. 216 (1931) (capital gains from the sale of municipal bonds may constitu-

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[7] The distinction between (1) a direct tax on an amount of income and (2) the use of that amount as a factor in a formula that calculates the tax on a different amount of income, has also been recognized outside the intergovernmental immunity context. This Court has repeatedly held that a state may take into account income or property outside its jurisdiction in computing the tax on income or property within its jurisdiction, even though the Due Process Clause would bar direct taxation of the extra-territorial income or property. See *Great Atlantic and Pacific Tea Co.* v. *Grosjean*, 301 U.S. 412 (1937); *Maxwell* v. *Bugbee*, 250 U.S. 525 (1919). And the old add-on minimum tax (26 U.S.C. (1976 ed.) 56) has been upheld against a challenge that it was not a tax on "income" because the formula for determining when the tax was triggered included consideration of items of capital recovery rather than income, such as depletion allowances and accelerated depreciation. See *Trainer* v. *United States*, 800 F.2d 1086 (Fed. Cir. 1986), cert. denied, No. 86-904 (Mar. 2, 1987).

tionally be subject to federal income taxation); *Greiner* v. *Lewellyn*, 258 U.S. 384 (1922) (transfers of municipal bonds may constitutionally be subject to federal estate and gift taxation). And, of course, federal income taxation of the salaries of state and local government employees, the constitutionality of which has been clear for almost half a century (see *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938)), has a much greater impact on local government finances than Section 86 could ever have. In sum, it is clear that the court of appeals correctly held that Section 86 does not exceed Congress's taxing power.[8]

2. For the reasons just discussed, petitioners' suggestion (Pet. 30-33) that the instant petition should be granted so that this case can be heard together with *South Carolina* v. *Baker*, No. 94, Orig., is manifestly inappropriate. The cases do not present the same question. The statute at issue in *South Carolina*, enacted in 1982, requires that municipal bonds be issued in registered rather than in bearer form in order for the interest paid thereon to be tax-exempt in the hands of the bondholder. See I.R.C. § 103(j). Although no state or local government has issued a registration-required obligation in bearer form, the *South Carolina* case does

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[8] The court of appeals also correctly rejected (Pet. App. 16-17) petitioners' Tenth Amendment claims (see Pet. 27-29). The power to tax private income has been expressly delegated to Congress, and hence the terms of the Tenth Amendment have no application here. And it cannot seriously be contended that the speculative and minor effect of Section 86 on the marketability of municipal bonds impairs the ability of any state " 'to function effectively in a federal system' " (Pet. 29, quoting *Fry* v. *United States*, 421 U.S. 542, 547 n.7 (1975)).

present, at least theoretically, the question whether Congress may ever impose a tax on municipal bond interest. The instant case, by contrast, does not involve any attempt by Congress to impose a tax on municipal bond interest. Hence, regardless of the outcome of *South Carolina* v. *Baker*, the court of appeals' decision here was correct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 86-1647

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

HARRISON J. GOLDIN, Comptroller of the City of New York, and THE CITY OF NEW YORK,

Petitioners,

-against-

JAMES BAKER, Secretary of the Treasury, of the United States,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF AMICUS CURIAE OF THE NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS AND THE POLITICAL SUBDIVISIONS OF STATES REPRESENTED BY THE AUTHORIZED LAW OFFICERS THEREOF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT FILED BY THE CITY OF NEW YORK

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS....(i)

TABLE OF AUTHORITIES....(ii)

INTEREST OF AMICUS CURIAE....1

STATEMENT OF THE CASE....4

SUMMARY OF ARGUMENT....4

ARGUMENT....4

FEDERALISM EMBODIED IN THE CONSTITUTION AND CASE LAW ALL SUPPORT THE CONTENTION THAT THE FEDERAL GOVERNMENT IS UNLAWFULLY IMPOSING A TAX ON MUNICIPAL BOND INTEREST

CONCLUSION....7

TABLE OF AUTHORITIES

Cases:

Page

Brushaber v. Union Pacific R. Co.,
240 U.S. 1 (1916) 7

Massachussetts v. United States,
435 U.S. 444 (1978) 5

Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) 5

Peck & Co. v. Lowe, 247 U.S. 165 (1918) 7

Pollock v. Farmers' Loan & Trust Co.,
157 U.S. 429, *opinion on rehearing*,
158 U.S. 601 (1895) 5, 7

Stanton v. Baltic Mining Co.,
240 U.S. 103 (1916) 7

Willcuts v. Bunn,
282 U.S. 216 (1931) 5, 7

Constitutional Provisions:

Tenth Amendment 2
Sixteenth Amendment 6, 7

Statutes:

26 U.S.C. § 86, Pub. Law 98-21 § 121,97
Stat. 65 (1983) ..... *passim*

Miscellaneous:

45 CONG. REC. 1694 *et. seq.* (1910) 6
45 CONG. REC. 2245, 2247 (1910) 6

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INTEREST OF THE AMICUS CURIAE

This brief *Amicus Curiae* is filed pursuant to Rule 36 of the rules of this Court on behalf of the more than 1,900 local governments that are members of the National Institute of Municipal Law Officers (NIMLO) in support of the City of New York, a NIMLO member. NIMLO is a national organization comprised of municipalities and local government units who are political subdivisions of

states within the terms of Rule 36.4 of this Court as this brief is sponsored by the authorized law officers of those who have signed it.

Member local governments operate NIMLO through their chief legal officer variously called city or county attorney, corporation counsel, city solicitor, law director, and other titles. The accompanying brief is signed by the attorneys constituting the governing body of NIMLO, both on behalf of NIMLO and as the authorized law officer of each of their political subdivisions of a State, Territory or Commonwealth.

NIMLO's member municipalities have a vital interest in the resolution of the question presented in this case; namely whether the Federal government may impose a tax on the interest Social Security recipients receive on the now tax exempt municipal securities they own in violation of the United States Constitution's Tenth Amendment[1] and the doctrine of intergovernmental tax immunity embodied in Federalism.

Section 86 of the Internal Revenue Code 26 U.S.C. § 86, Pub. Law 98-21 § 121, 97 Stat. 65 (1983)[2] adopted in 1983 imposes Federal income taxes on income received by certain owners of municipal bonds who receive Social Security benefits. The formula used for imposing the tax under Section 86, imposes the tax upon any person who both owns municipal bonds and is a Social Security beneficiary. A few exceptions are provided based upon amount of income. This is a national issue, not just one affecting New York City. Section 86 imposes Federal income

[1] See Petitioners' Petition page 4 for text.

[2] *Ibid.* Pages 5-6 for text.

tax upon the group of municipal bond purchasers most likely to buy municipal tax exempt bonds, i.e., those earning over $25,000.

The tax is stated to be a tax upon Social Security benefits but the tax in many cases applies when a Social Security beneficiary receives income from tax exempt bonds. Hence, while the tax is in words a tax on Social Security benefits it is actually a tax upon tax exempt securities income.

Such a tax, if not found unlawful, will severely increase the interest cost all cities must pay therefore curtailing the municipality's ability to borrow money needed to fund essential services and capital projects. Should this Federal tax continue to remain on local government securities, additional funds will have to be appropriated to maintain the current level of financial support provided by now tax exempt municipal bond purchasers. Additional municipal appropriations will be needed to cover the increase in interest a municipality would have to pay on its securities; an increase necessary to overcome the adverse effect of the Federal government's unlawful tax.

Such a tax is a serious breach in the agreement the Constitution provides to reciprocally respect the sovereignty of the Federal government and the States and their political subdivisions. The agreement that the Federal government could not tax interest from state and muncipal bonds has been upheld by this Court for nearly 100 years. For the Federal government to extend its considerable power of taxation beyond that delegated by the Constitution at the expense of state and local governments is an egregious violation of the principles of Federalism. Such action is not in the public interest and severely hampers New York City and other municipal members of NIMLO from exer-

cising their constitutionally protected rights. Consequently, NIMLO members urge this Court to grant New York City the Writ of Certiorari it seeks and reverse the judgment rendered in this case by the United States Court of Appeals for the Second Circuit.

STATEMENT OF THE CASE

The statement of the case as set forth in Petitioner's Petition for Writ of Certiorari is adopted by Amici for purposes of this brief *amicus curiae*.

SUMMARY OF ARGUMENT

The Second Circuit did not abide by the decisions of this Court in finding no constitutional violations by the Federal income tax imposed by Internal Revenue Code Section 86 on income earned by municipal securities. Such a ruling contravenes decisions of this Court dating back to 1895 which hold such a tax violates the doctrines of reciprocal tax immunity and Federalism. Petitioners' Writ of Certiorari should be granted and the Second Circuit's decision should be reversed to remove the burden thereby placed on municipalities' attempts to raise funds for essential public services through the issuance of municipal securities.

ARGUMENT

Federalism Embodied in the Constitution and Case Law All Support the Contention that the Federal Government is Unlawfully Imposing Tax on Municipal Bond Interest

When drafting the Constitution nearly 200 years ago, the Founding Fathers were quite cognizant of the need to keep the National Government, thereby created, from violating the sovereignty of the States and their political sub-

divisions. This wariness of a central Federal Government operating at the expense of the States is reflected throughout the Constitution and the debates during its drafting and ratification. Such respect for the sovereignty of state and local government is the overriding concern in the development of Federalism in American law.

Nearly 100 years ago this Court recognized the constitutional barriers preventing the Federal Government from violating the concepts of Federalism by seeking to collect revenue from the States. In *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *opinion on rehearing*, 158 U.S. 601 (1895) this Court held that state and local bond interest is constitutionally immune from federal income taxation. In *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 522 (1926) it was stated that income derived from the ownership of municipal bonds was so intimately connected to the sovereign borrowing power that such interest income was likewise constitutionally immune from federal taxation. This immunity doctrine as described in these cases and their progeny have survived to this day, providing necessary protection for the delicate balance of power between the States and the Federal Government. See *Massachusetts v. United States,* 435 U.S. 444 (1978).

Before the Court in this case is a threat to that balance of power between sovereigns. Petitioner, a political subdivision of a State, is challenging a Federal law which violates the constitutional barriers erected to protect the system of Federalism in this Country. That law, 26 U.S.C. § 86, states that otherwise tax-exempt interest earned on municipal securities is to be treated as income in determining whether Social Security benefits are to be taxed. This law is in direct conflict with this Court's decisions in *Pollock, supra, Willcuts v. Bunn*, 282 U.S. 216 (1931) and *Massachusetts, supra.* The Court of Appeals for the Second Circuit was incorrect in determining that Section 86

is constitutional since it taxes Social Security income rather than imposing the tax on municipal securities. The Court erred in failing to recognize in many cases additional tax an individual would have to pay under Section 86 is entirely due to the existence of income from municipal securities. The greater such income, the greater the tax burden and this type of tax is what this Court has previously found unconstitutional. By failing to follow this Court's decisions, the Second Circuit has significantly contributed to the erosion of municipal borrowing authority. The Circuit's decision will force municipal bond issuers to raise interest rates to retain their current level of competitiveness in the bond market. This added expenditure municipalities will have to provide will impair their ability to raise revenue and fund essential public services.

The Sixteenth Amendment[3] to the Constitution does not provide power to the Federal Government to tax municipal interest income. The history of the Amendment reflects the intent of its sponsors to prohibit the Federal Government from imposing costs which are in effect a tax on the interest of state and local government bonds. There was never any suggestion made in Congress that the Sixteenth Amendment involved the taxation of municipal bond interest. In fact, when the Amendment was before the States, several members of Congress assured state officials that its language would not lend itself to such an interpretation.[2]

This Court in 1916 held that the Amendment added no new subject to the taxing power of Congress, but merely

[3] "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." (adopted 1913).

[4] See Statements of Senator Borah, 45 CONG. REC. 1694 *et. seq.* (1910); Senator Brown, 45 CONG. REC. 2245, 2247 (1910).

eliminated the apportionment requirement of *Pollock*. *Brushaber v. Union Pacific R. Co.*, 240 U.S. 1, 11 (1916); *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112 (1916). The Court reached the same conclusion in *Peck & Co. v. Lowe*, 247 U.S. 165, 172 (1918) and *Willcuts, supra.* To the extent it found the Sixteenth Amendment supports the Section 86 provision of the Internal Revenue Code the Second Circuit has erred. The Second Circuit rejection of this Court's reasoning in *Pollock, supra,* and its progeny and its misconstruance of the effects of the Sixteenth Amendment will put a severe impairment on local governments' ability to raise needed revenue. The Petitioner, City of New York, raises a serious constitutional question which was answered incorrectly by the Second Circuit's decision. Only this Court may rectify the situation and restore order to the municipal bond market by granting the Petition for a Writ of Certiorari herein and reversing the Second Circuit's erroneous decision.

CONCLUSION

For the foregoing reasons, Amicus respectfully urges that Petitioners' Petition for Writ of Certiorari be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

Jan Majewski, attorney for amicus, certifies that on May 12, 1987, he caused three copies of the foregoing brief to be delivered to Peter L. Zimroth, Corporation Counsel of the City of New York; Leonard J. Koerner, Assistant Corporation Counsel; Fay Leoussis, Assistant Corporation Counsel; and Barry P. Schwartz, Assistant Corporation Counsel, Attorneys for Petitioners, New York City Law Department, 100 Church Street, New York, NY 10007. Three copies of the foregoing brief were also delivered to Charles Fried, Solicitor General, U.S. Department of Justice, 10th and Constitution Ave., N.W., Washington, D.C. 20530, Attorney for Respondent on May 12, 1987.

The briefs were delivered by placing said briefs in the United States Postal Service mail addressed to each of said counsel with required postage affixed thereon.

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May 12, 1987